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Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, PETITIONER,

v.

DAKOTA-MONTANA OIL COMPANY.

On Writ of Certiorari to the Court of Claims.

BRIEF ON BEHALF OF RESPONDENT.

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Supreme Court of the United States.

October Term, 1932.

No. 434.

THE UNITED STATES, *Petitioner,*
v.
DAKOTA-MONTANA OIL COMPANY.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR THE RESPONDENT.

OPINION BELOW.

The findings of fact and the opinion by the Court of Claims are reported in 59 Fed. (2d) 853.

JURISDICTION.

The judgment of the Court of Claims was rendered on July 5, 1932 (R. 16). Petition for writ of certiorari was filed on October 5, 1932 (R. 16). Jurisdiction is invoked under the authority of Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. The writ of certiorari was granted on November 14, 1932 (R. 17).

QUESTION PRESENTED.

Whether under the Revenue Act of 1926 an allowance should be made for depreciation upon the costs of drilling oil wells, the wells upon which the expenditures were so made resulting in producing wells, the production of oil from

such wells being included in the income for the taxable year involved and the expenditures for the drilling costs having been capitalized?

THE STATUTES AND TREASURY REGULATIONS.

The pertinent portions of the Revenue Act of 1926 (Ch. 27, 44 Stat. 9, 16, 41) are as follows:

"Sec. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—* * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." * * *

The following articles of Regulations 69, promulgated under the Revenue Act of 1926, are pertinent:

"DEDUCTIONS ALLOWED CORPORATIONS.

"Art. 561. *Allowable deductions.*—In general the deductions from gross income allowed corporations are the same as allowed individuals, * * *. Particularly, * * * as to

depreciation, see articles 161–170; as to depletion, see articles 201–237; * * *."

"Art. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"Art. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation * * *."

"Art. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)"

STATEMENT OF FACTS.

The respondent constructed producing oil wells and charged the entire cost of such construction to invested capital.

The Government has attempted to segregate the entire cost of constructing the completed oil well into three classes of expenditures as follows:

1. The cost of equipment and materials;
2. The cost of freight, hauling, and installing equipment and materials, and
3. The cost of drilling the wells, including the labor, fuel, etc., in such drilling.

The Commissioner of Internal Revenue then allowed a depreciation only upon the costs of the equipment and materials and refused to allow a depreciation upon the other two elements of cost of constructing a completed oil well.

After suit was brought in the Court of Claims to recover the increased taxes paid because of the disallowance of depreciation on the other tw items of cost, the Government conceded in the Court of Claims that depreciation should have been allowed upon the second item of cost, namely, the cost of freight, hauling, and installing the equipment and materials (R. 10.) This item alone results in an overpayment of tax in the sum of $8,420.21, plus interest as provided by law, which sum was included in the judgment for respondent in this case (R. 9).

The Government apparently did not make the same concession in the case of *Burnet, Commissioner*, v. *Petroleum Exploration*, 61 Fed. (2d) 273, since the court in that case expressly decided that such costs should be depreciated (see page 277).

The Government refused to allow any depreciation upon the third class of costs of constructing a producing oil well and the Court of Claims disagreed with this action and included in its judgment the increased taxes paid because of this disallowance.

In the *Petroleum Exploration* case (*supra*) the Commissioner also disallowed any depreciation upon this third class

of costs. The Board of Tax Appeals (23 B. T. A. 890) disagreed with the disallowance, but the Circuit Court of Appeals for the Fourth Circuit (61 Fed. (2d) 273) agreed that the Commissioner was right in not allowing any depreciation upon this third class of costs and in this respect reversed the decision of the Board of Tax Appeals.

The pertinent facts in the case now before this court as such facts were found by the Court of Claims (R. 5–9) are as follows:

The respondent, a North Dakota corporation, during the pertinent times was engaged in developing and operating oil properties, including the procuring of leases on oil lands, drilling, owning and operating oil wells and building, erecting, constructing and owning the necessary camps and equipment for the construction and operation of oil wells. It kept its books and made its income tax return for the calendar year 1926 on an accrual basis (R. 5). During the years 1923 to 1926, both inclusive, respondent expended a large sum of money for labor, fuel, hauling, freight, supplies, material and equipment used in drilling oil wells, casing the same, erecting derricks and camps, and equipment for the operation of such wells, and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line (R. 5). The findings of fact show the amounts spent each year for the following separate divisions of expense: (1) Cost of equipment and materials; (2) Cost of freight, hauling, and installing equipment and materials, and (3) Total cost of drilling, such as fuel, labor, etc. (R. 5). All of these expenditures were capitalized by respondent and included in its invested capital. The productive life of all of these producing wells, the expenditures for which were so capitalized, was more than one year (R. 6). The findings of fact also show the estimated oil reserves on the properties upon which these expenditures were made during the pertinent years, and show the amount of oil produced from such properties during the calendar year 1926 (R. 6).

In the computation of its income tax for the year 1926 the respondent claimed a deduction of 27½ per cent of its

gross income from these properties during the taxable year for depletion in accordance with the provisions of the statute, and also claimed a depreciation upon a unit of production basis upon the total amount expended in the drilling and completion of such producing oil wells (R. 7). The Commissioner of Internal Revenue then allowed the deduction for depletion as claimed, but allowed a deduction for depreciation only upon (1) the costs of the equipment and materials and rejected the claim for a depreciation upon the cost of (2) freight, hauling, and installing equipment and materials, and (3) the total cost of drilling, including the labor, fuel, etc. (R. 7).

The respondent then brought this action in the Court of Claims to recover the tax imposed and collected by the Government because of the disallowance of the depreciation claimed, and the Government conceded in the Court of Claims that an allowance for depreciation should be made not only upon the cost of equipment and materials which the Government had previously allowed but also that an allowance for depreciation should be made upon the cost of freight, hauling and installing of the equipment and materials (R. 10), which concession resulted in an admitted overpayment of tax by respondent in the sum of $8,420.21 (R. 9). The Government, however, contended that the actual cost of drilling the well, including the labor, fuel, etc., that is the cost of putting the drill hole in the ground, should not be made the subject of depreciation, but was covered by the allowance for depletion (R. 10). The Court of Claims determined that not only (1) the costs of the equipment and materials and (2) the cost of the hauling, freight, installing, etc., of the equipment and materials should be subjected to an allowance for depreciation, but that the entire cost of creating the producing oil well including (3) the drilling costs should be made the subject of an allowance for depreciation (R. 9 to 14) and rendered its judgment accordingly.

During the calendar years 1922, 1923, and 1924, the respondent had charged as operating costs certain expenditures made by it for early and preliminary costs incident to the oil leases and preliminary to the drilling, construction, and

completion of the oil wells (R. 8). The Government required the respondent to set up said expenditures in its tax returns for the calendar year 1926 as capital investments, and accordingly increased respondent's capital investment for that calendar year in the amount so set up (R. 8). The respondent claimed a deduction for depreciation upon these expenditures and the Court of Claims allowed such depreciation. The Court of Claims rendered judgment for the respondent for the principal sum of $19,096.12 (R. 16), which included the sum of $8,420.21 conceded by the Government.

SUMMARY OF ARGUMENT.

The statute requires the allowance of a depreciation upon the costs here in question. A proper interpretation of the Regulations also requires the allowance of such depreciation. They both require the allowance of depreciation upon improvements and physical properties. A completed oil well should be considered as a whole and a unit and as such is both an improvement and a physical property. It is arbitrary and unreasonable to attempt to separate into classes the costs of constructing a completed oil well and allow a depreciation upon only a part of such costs. If the Regulations do not permit a depreciation upon the costs of drilling the oil well then such regulations are contrary to the statute, unreasonable, arbitrary and inconsistent with other parts of the Regulations and must therefore be disregarded.

ARGUMENT.

I. *Both the statute and the regulations require a depreciation upon the drilling costs.*

It is well recognized that it was the purpose and intent of the Federal income tax laws to lay a tax upon net income only and that the purpose of many of the provisions of the taxing statutes permitting the allowance of deductions from gross income in order to arrive at the net income upon which the tax is to be computed is to exclude from the net income a

return of invested capital and thus not lay a tax upon the return of such invested capital.

It is in accordance with this well established plan that Section 234 (a) (8) of the Revenue Act of 1926 provides that:

"(a) In computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *"

This statute expressly requires that both depletion and depreciation shall be allowed. There is no uncertainty or ambiguity in such provision but it is definite and mandatory.

It is also the purpose of this section to allow a depreciation upon the costs of the improvements made by man upon the property so as to permit a return by way of depreciation allowances of the capital invested in the same and also to permit a depletion upon the value of the oil deposit placed there by Nature, the depletion allowance taking care of the actual cost of the deposit and making also an allowance for the discovery value covered by prior Revenue Acts.

Depletion and depreciation are separate and distinct. Each has a well defined meaning. The word "depletion" is derived from the Latin word "deplere," meaning to empty or exhaust. "Depreciation" is derived from the Latin word "depretaire," meaning to lessen in price or value. The word "improvement" also has a well known meaning, and is defined as being that by which the value of anything is increased or as an amelioration of the condition of property affected by the expenditure of labor or money for the purpose of rendering it useful for other purposes than those for which it was originally used, or more useful for the same purpose.

Applying these definitions to the statute, it means that there shall be in the case of oil wells or other natural deposits

a reasonable allowance for the emptying or exhaustion of the deposits, and a reasonable allowance for the lessening in value of the increased value of the property resulting from the expenditure of labor or money. The decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295, clearly shows that such definition and meaning was that which Congress had in mind in the Revenue Acts relating to oil wells. At p. 300 the court said:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. * * *"

Again, on p. 302, the court said:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

The Supreme Court then pointed out that the Corporation Tax Law of 1909 contained no provision for deductions on account of depletion of mineral reserves and, at page 303, said:

"The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on account of depletion in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. It is argued that, because oil is a fugacious mineral, it can not be known that the reserve has been diminished by the operation of wells. Perhaps some land may be discovered which, like the Widow's cruse, will afford an inexhaustible supply of oil. But the common experience of man has been that oil wells, and the territory in which they are sunk, become exhausted in time. Congress in providing for the deduction for depletion of oil wells acted on that experience. Compare *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. In essence, the deduction for depletion does not differ from the deduction for depreciation."

In the *Ludey* case this court holds that the allowance for depletion was to represent a reduction in the mineral content of the reserve, and was separate from a depreciation of improvements. The court points out that the proviso in the law limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction was to be regarded as a return of capital and not as a special bonus for enterprise and willingness to assume risks. The *Ludey* case was decided under the Revenue Act of 1916. In the Revenue Act of 1918 Congress went further and provided for a depletion allowance based upon a discovery value which included something in the nature of a special bonus for enterprise and willingness to assume risks. After that the depletion allowance was not confined to a return of capital invested in the oil reserves.

Under the Revenue Act of 1918 and all acts subsequent thereto up to the Revenue Act of 1926, the following procedure was followed in determining the basis of the depletion allowance: (a) If the property was acquired prior to March 1, 1913, then the fair market value on that date might be used in lieu of the cost of the property; and (b) if the oil was discovered on or after March 1, 1913, where the fair market value was materially disproportionate to the cost, the depletion allowance was based upon the fair market value at the date of discovery or within thirty days thereafter.

(See Sections 214 (a) (10) of the Revenue Act of 1918, also Sections 201 to 206 of Regulations 45.)

In the Revenue Act of 1921 it was provided that the allowance for depletion should not exceed the net income for the year and in the Revenue Act of 1924 there was placed a limitation that the allowance for depletion should not exceed fifty per cent of the net income for the year.

The Revenue Act of 1926 changed this allowance for depletion. Great difficulty had been experienced in the determination of the so-called discovery value and in order to simplify the matter Congress provided for a flat and arbitrary deduction of 27½ per cent of the gross income for depletion. This was to cover the value of the mineral deposit, including the discovery value.

All of this is very clearly shown by the legislative history of the Revenue Act of 1926. It is well settled that reports of committees of the House and Senate as well as explanatory statements in the nature of a supplemental report made by the committee members in charge of a bill in the course of passage may be considered by the courts and regarded as an exposition of the legislative intent and purpose of the law-making body.

(*Binns* v. *United States*, 194 U. S. 486, 495; *Duplex Co.* v. *Deering*, 254 U. S. 443, 474, 475.)

The Revenue Act of 1926 was H. R. 1 in the 69th Congress, 1st Session. As the bill was reported to the House, it contained provisions allowing a depletion upon discovery value, but limiting that to areas outside of a square of 160 acres, using the producing well as the center (House Report No. 1,

69th Congress, 1st Session, page 6). But in the Senate the bill was reported to allow a flat deduction of 25% of gross income instead of the depletion based on discovery value (Senate Report No. 52, 69th Congress, 1st Session, page 17, 18). This action is there explained as follows:

"Section 204 (c) and (d): The basic changes made in the discovery depletion provision by the House were explained in a Report of the Ways and Means Committee, as follows:

" 'The committee feels that the deduction for discovery depletion should be limited somewhat further than it was limited in the revenue act of 1924, and in addition that there should be incorporated in the act the Treasury regulation defining a proven area. Under the existing law, discovery depletion is allowable to one who brings in a well upon property proven at the time the well is brought in, if at the time it was purchased by the taxpayer it was not proven. Obviously the benefits of discovery depletion, the purpose of which was to encourage the wildcatter or pioneer, should be limited to those who make an actual discovery. Furthermore, in the interest of certainty and clarity, it is thought advisable to incorporate in the law a definition of what is a proven area. With these two objects in mind the committee recommends the amendments of the discovery provision contained in the bill. The new subdivision provides that in the case of oil and gas wells discovered by the taxpayer on and after January 1, 1925, in an area not proven at the date of such discovery, where the fair market value of the property is materially disproportionate to cost, the basis for depletion shall be the fair market value at the date of discovery or within 30 days thereafter of the property proven by such discovery and included within the taxpayer's tracts or leases. The subdivision further provides that in the case of oil or gas wells, each well producing oil or gas in commercial quantities shall be considered as having proven at least that portion of the productive sand, zone, or reservoir which is included in the square surface area of 160 acres having as its center the mouth of such well. The amendment further provides that in case two or more persons enter into an agreement whereby the cost of the well shall be shared if oil or gas in commercial quantities is not found, such well shall not be considered as having proven any part of the tract or lease held by such other persons. The discovery depletion deduction limitation of an amount not in excess of 50 per cent of the net income of the taxpayer

from the property upon which the discovery was made, provided in existing law, is retained in this provision.'

"The amendment proposed by your committee makes only one basic change in the discovery depletion provision of existing law so far as such provision relates to mines. It enlarges the present discovery provision in the case of mines by permitting a deduction for discovery value in the case of discoveries of minerals discovered or proven in an existing mine or mining tract after February 28, 1913, not included in any prior valuation.

"The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained."

Senator Reed, a member of the Senate Committee which reported the bill and who was in charge of the same on the floor of the Senate, said:

"Mr. REED of Pennsylvania. No; it would not happen. If we were to calculate the depletion at some fixed percentage of the cost of the property that would not occur. But ever since early war days Congress has followed the policy of allowing what they call discovery value for both oil and gas wells and for minerals. It is perfectly obvious that if I buy an acre of land in the Rocky Mountains and pay $10 an acre for it, and then, by hard work, discover a rich deposit of gold in it, the calculation of my depletion on the original $10 basis would not allow me any adequate return for my real capital. So, in allowing what is called discovery value, Congress and the bureau have tried to get at the real but the unknown value of the property owned by the taxpayer.

"Whether it is wise to handle the problem in that way or not I am not entirely persuaded. It has led to some large deductions from income, but to refuse to do it and to calculate the depletion on the original cost is not fair, either, because in these uncertain industries there is much property which is bound to be worthless, on which the taxpayer really

makes a dead loss; but there is no production and consequently no depletion from that property.

"Mr. KING. And no tax.

"Mr. REED of Pennsylvania. And no tax.

"Mr. COUZENS. Does the Senator know of any other industry where that is allowed?

"Mr. REED of Pennsylvania. The production of minerals is the only one that I know of—either oil or gas or solid minerals. It is only in the production of such minerals that the element of uncertainty enters so largely."

Congressional Record, Vol. 67, part 4, page 3762 (69th Congress, First Session). This is further emphasized by the provisions of Regulation 45 issued under the Revenue Act of 1918, especially Articles 201 and 219.

It is clearly shown by the foregoing that discovery value and depletion based thereon was never intended to be limited to a return of the money actually invested in the particular oil reserves upon which the allowance is made. It was realized that there was a peculiar situation in the oil industry which had to be dealt with differently from other industries. For example, the oil man may acquire a piece of land or an oil lease on unproven land for $10; he may spend $5,000 in exploration and investigation and $100,000 in drilling oil wells and have only dry holes which produce no oil. Therefore, such a pioneer would have no income from which to recoup his invested capital by way of depletion and depreciation. He may well continue this program and after many unsuccessful attempts get a well that after it is brought into production has a value of $1,000,000. If, however, as the oil is produced he is to be allowed a depletion upon the cost of $10 plus the $5,000 exploration and investigation expense and a depreciation upon the cost of constructing the well, he will be taxed upon a very large sum each year as the oil is produced and never have any opportunity to recoup, either by way of depletion or depreciation, the cost of the unsuccessful wells which were in reality only a part of the costs of exploration preliminary to the finding of the producing well. Therefore, in order to encourage the bringing into existence of new wells and new oil production,

the Revenue Act of 1918 provided for a depletion upon a discovery value which had no relation to the money spent on the producing well on which the allowance was made.

It is respectfully submitted that Congress specifically provided in Section 234 of the Revenue Act of 1926, that there should be an allowance for depletion or exhaustion of the natural deposits, that is, an allowance for the diminution of that which had been placed upon the property by Nature. Congress further provided that there must be a reasonable allowance for the depreciation of improvements, that is, an allowance for the diminution in value of that which had been placed upon the property by man.

It is further submitted that a proper construction of the regulations issued by the Treasury Department is not at all in conflict with this expressed purpose and intent of Congress, but is in full accord with the same.

The Commissioner in Article 221 of the Regulations provides that the taxpayer may deduct on account of depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year. He thus clearly recognizes the necessity and correctness of an allowance for depletion and in his determination of the method of arriving at the amount of depletion he merely adopts the method specifically provided for the determination of such amount in Section 204 (c) (2) of the Revenue Act of 1926.

Article 223 of the Regulations undertakes to give to the taxpayer the option of charging drilling costs to operating expenses or to invested capital, and provides that if charged as operating costs all may be deducted in the year in which expended. This regulation further provides that if these expenses are charged to invested capital, in so far as they are represented by physical property, they may be taken into account in determining a reasonable allowance for depreciation. This is a recognition again that there must be an allowance for both depreciation and depletion.

Article 225 of the Regulations provides that, in addition to and apart from the deduction allowable for depletion, there will be permitted a deduction of a reasonable allowance for depreciation of physical property such as machinery, tools,

equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under Article 223, and that the amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired, and that where it can be shown that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property then the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. The provision permitting the calculation of depreciation upon the basis of the unit of production is wholly inconsistent with any theory that limits depreciation to wear and tear. It recognizes that the useful life of the investment may come to an end long before there is even any wear or tear but that still the investment should be returned during the useful life regardless of wear and tear.

In these regulations the Treasury had expressly recognized the mandatory requirement by Congress that there shall be allowance not only for depletion but also for depreciation, and it is respectfully submitted that a proper construction of these regulations recognizes the true distinction between the allowance for depletion and depreciation, namely, that depletion should be allowed for the lessening in value of the oil deposits which were placed there by Nature, and depreciation shall be allowed for the lessening in value of all improvements placed there by man. Such a construction is consistent with the express words and purpose of the statute, also with the true and well understood meaning of the terms depletion and depreciation, and with the decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295.

The facts in this case show that the expenses upon which respondent has been allowed by the Court of Claims a deduction for depreciation are all the costs of erecting and constructing a completed oil well, which includes not only the costs of the material and equipment, and the costs of

hauling, freight, etc., upon such materials, but also the cost of drilling the oil well.

The regulations permit a depreciation upon expenditures represented by physical properties. *Physical* has been defined as relating to what is material and perceived by the senses, specifically pertaining to the material part or the structure of an organized being as opposed to what is mental or moral. It is also defined as that which is external, obvious to the senses and cognizable through a bodily or material organization.

Physical properties mean those properties which can be seen, and which are obvious to the senses, as opposed to those which are mental or moral and have no definite existence.

The Government in the application of the regulations has decided that the completed oil well shall not be considered as a whole and as constituting an improvement as a whole, but has held that the completed oil well as a whole is not a physical property as the term is used in the regulations. It has therefore arbitrarily divided the costs of erecting a completed oil well into three classes. It at first decided that only one class of these costs is represented by physical properties and constitutes improvements upon which depreciation can properly be allowed. Later, the Government conceded n court in this case that another class of costs should be subjected to an allowance for depreciation, but still urged that the drilling costs should not be subjected to depreciation.

The respondent urges that the completed oil well should be considered as a whole and not arbitrarily divided into parts, and that the completed oil well as a whole is an improvement as used in the statute and a physical property as used in the regulations. The respondent further contends that therefore all of the costs of constructing the completed oil well as a whole and as an entirety should be made the subject of a deduction for depreciation.

The respondent submits that a completed oil well is a physical thing. It is also an improvement or an addition to the property. It can be seen. It can be touched. It

performs a useful function or duty. It is obvious to the senses. It has no purely mental, moral, or intangible characteristics. An oil well consists of an aggregation of physical things such as pipes, sleeves, derricks, pumps, various articles of steel, timber, etc., and before the oil well as such and as a completed structure is brought into existence all of these component parts must be brought together and put together to produce the ultimate physical object which is the completed oil well. Without the labor of drilling the hole, the fuel to run the drill, the freight, the hauling of the casings, and the materials themselves, and all of such things for which these expenditures were incurred, these objects would never produce a completed oil well which, as above stated, is the ultimate physical object here involved, but such parts would always remain only component parts thereof scattered at distant points over the face of the earth.

A producing oil well is a physical property. The mere fact that a portion thereof is extended into the bowels of the earth does not prevent it from being a physical object or physical property. It is a structure and is the result of a construction project. The hole in the ground is as much a part of the completed oil well as any other component part such as casings, derricks, etc. Without the hole in the ground the oil well could not be completed or brought into existence.

It is respectfully submitted that even a mere hole in the ground which is constructed by man is a physical object. When constructed for the purpose of being used as an oil well or even as a well for drinking water, it is a physical thing, it becomes physical property, and is an improvement upon the premises.

In the recent case of *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551, the Board of Tax Appeals had for consideration the question whether a deduction should be allowed from income for the years 1922, 1923, and 1924, governed by the Revenue Act of 1924, for depreciation upon these so-called drilling costs, and decided in accordance with the contentions of respondent. Remarks by the Board in that decision are sound and very persuasive. Such remarks (p. 562) are in part as follows:

"The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067; *Old Farmers' Oil Company*, 12 B. T. A. 203. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States* v. *Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon Article 223 of Regulations 62 which provides:

" 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer* charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *' (Italics supplied.)

If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that "are represented by physical property while other costs were not." The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all "represented by physical property." The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling "in connection with development and drilling." This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment

of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures.

This case was recently reversed by the United States Circuit Court of Appeals for the Ninth Circuit (decision as yet unreported), but the reversal was upon other grounds, and the conclusion by the Board of Tax Appeals upon the question of depreciation was not discussed or disturbed.

The Board of Tax Appeals has also followed this ruling in *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Company* v. *Commissioner*, 24 B. T. A. 360. The United States Circuit Court of Appeals for the Fourth Circuit has reversed the Board of Tax Appeals in the *Petroleum Exploration* case. The opinion is reported at 61 Fed. (2d) 273, and a copy is printed as an appendix to the petition for writ of certiorari herein. This decision will be hereinafter discussed.

The Government contends that the cost of drilling the hole in the ground is more directly related to the value of the mineral deposit and therefore should be returned through the allowance for depletion instead of the allowance for depreciation, and that the hole in the ground does not wear out and therefore can not be made the subject of depreciation. The same theory was followed in the dissenting opinion in the Court of Claims (R. 15) where it was said:

"An oil well, that is, the hole in the ground, like real estate, is not naturally subject to depreciation through wear and tear. Its usefulness is exhausted as the oil is removed, but exhaustion is comprehended in the allowance for depletion. In the ordinary case the statute provides for a reasonable allowance for 'the exhaustion, wear, and tear of property used in the trade or business,' but in the case of oil wells the statute, section 234 (a) (8) of the Revenue Act of 1926, in providing for a deduction for depletion and for wear and tear, states that 'In the case of * * * oil and gas wells * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the

commissioner with the approval of the Secretary.' The costs which may be included in the amount to be used for the purpose of computing the allowance for depreciation must be costs in relation to physical property which is subject to depreciation through wear and tear as distinguished from exhaustion. The deduction for depletion is a special application of the general rule allowing a deduction for exhaustion. The depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. The depletion is likened to the using up, i. e., exhaustion, of raw material in a manufacturing process. The terms 'depletion' and 'depreciation' are mutually exclusive; together they are the equivalent of the phrase 'exhaustion, wear, and tear'; in the case of an oil well, however, the exhaustion is described as depletion. In view of the particular language of section 234 (a) (8) relating to oil and gas wells, I think exhaustion was intended to be included in the depletion allowance of 27½ per cent of the gross income from the property during the taxable year, and only compensation for wear and tear of physical property allowed in addition thereto."

The same idea was discussed to some extent in the decision by the Circuit Court of Appeals in *Burnet* v. *Petroleum Exploration*, 61 Fed. (2d) 273, 276.

This theory is erroneous. It is inconsistent with the action by the Government and the court with respect to other elements in this case.

The Government at first held that the costs for the freight on the materials and equipment and the hauling of same to the site of the oil well must be recovered through depletion and not through depreciation. However, it conceded in the Court of Claims that depreciation should be allowed upon these costs. The dissenting opinion agrees that this is a proper item for depreciation (R. 14), and the Circuit Court of Appeals in the *Petroleum Exploration* case also agrees to this (61 Fed. (2d) 273, 277). Certainly it can not be said that this freight and hauling or the expenditures for the same are subject to wear and tear. The useful life or usefulness of same of course becomes exhausted. These items or expenditures can not be removed and used elsewhere. They have no salvage value. They have a value

and usefulness only connected with the one oil well. When the oil in that well is exhausted, these expenditures become absolutely worthless. They are as closely connected with the life of the reserve as the usefulness of the hole in the ground. What has been said above also applies with equal force to the cost of installing the equipment. Yet the Government now concedes and all agree that these costs shall be made the subject of depreciation. These installation costs include many items. It is a matter of common knowledge that engines must be used to pump the wells. These engines are mounted or set on heavy concrete bases and holes are dug into the ground in which to make foundations for these bases. There is no wear and tear on these holes in the ground for the foundations, or the foundations themselves or the concrete bases. They can not be moved or salvaged. The usefulness of these things and the value of the expenditures for the same are ended and destroyed when the oil ceases to exist in the well. Yet, as above stated, these costs are depreciated.

In reality the cost of drilling the hole in the ground may be properly considered a part of the cost of the installation of the materials and equipment and all now agree these costs should be depreciated. The drilling of the hole is nothing more than the construction of the receptacle for the casings and other materials and equipment. Without the hole the casing could not be installed.

The argument of the Government and the dissenting opinion in the Court of Claims would limit depreciation to the cost of articles which wear out and include in depletion the deductions because of the lessening of value of the mineral deposit and the lessening of value of investments for things which do not wear out but whose useful life is shortened as the mineral deposit becomes exhausted. It is said in this dissenting opinion, "The costs which may be included in the amount to be used for the purpose of computing the allowance for depreciation must be costs in relation to physical property which is subject to depreciation through wear and tear as distinguished through exhaustion. The deduction for depletion is a special applica-

tion of the general rule allowing a deduction for exhaustion. The depreciation charge represents the reduction during the year of the capital assets through wear and tear of the plant used. The depletion is likened to the using up, i. e., exhaustion of raw material in a manufacturing process. The terms 'depletion' and 'depreciation' are mutually exclusive; together they are the equivalent of the phrase 'exhaustion, wear and tear.' " In other words, this theory would allow depreciation upon only those things which are subject to wear and tear and would include in depletion everything whether it was an actual exhaustion of the natural deposit or only a wearing out or exhaustion of the useful life of the property simply because its value became lessened because of the exhaustion of the natural deposit upon the existence of which the usefulness of the investment depended.

It is apparent that Congress had no such an idea in mind and did not consider all forms of exhaustion as included in the term depletion. In Sec. 204 (c) of the Revenue Act of 1926, Congress said: "The basis upon which depletion, exhaustion, wear and tear and obsolesence are to be allowed," etc. It can not be said that the phrase "exhaustion" is surplusage and meaningless, yet that would be the effect if the term depletion included the allowances for the lessening in value of the useful life of investments.

The term depletion is used nowhere in the statute except with reference to "mines, oil and gas wells, other natural deposits, and timber." In all other properties exhaustion, wear and tear and obsolescence are all covered by the allowances for depreciation.

Sec. 214 (a) (8) expressly requires the deduction of "a reasonable allowance for exhaustion, wear and tear of property used in trade and business, including a reasonable allowance of obsolescence." Article 161 of Regulations 69 quotes this section of the statute under the heading "Depreciation" and says:

"A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or

business may be deducted from gross income. For convenience, such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with Section 204 and Articles 1591–1603."

In this general regulation applicable to all industries, exhaustion of the useful life was expressly included in the term depreciation whether such exhaustion resulted from wear and tear or otherwise. This regulation had been in existence for many years.

Article 162, headed "Depreciable property," says:

"The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art * * *. It does not apply to bodies of minerals which through this process of removal suffer depletion, other provisions for this being made in the statute * * *."

Article 163 headed "Depreciation of intangible propety" says:

"Intangibles, the use of which in trade or business is definitely limited in duration, may be the subject of a depreciation allowance."

Article 164 says:

"The capital sum to be replaced by depreciation allow-

ances is the cost or other basis of the property in respect of which the allowance is made."

Article 165 says:

"The capital sum to be replaced should be charged off over the useful life of the property * * *."

In dealing with timber properties, Article 232, headed "Depreciation of improvements in the case of timber," says:

"The cost or value as of the basic date, as the case may be, of development not represented by physical property having an inventory value shall be recoverable through depreciation."

It then provides that such costs may be recovered upon a unit of production basis. This does not exclude properties except those which are subject to wear and tear. It includes in depreciation such costs as are exhausted only because of the ending of the useful life of the property. It includes such costs as skidways, temporary roadways which will have no value except in connection with the timber and the life of the timber supply upon the tract or area.

All of the above clearly shows that the regulations did not confine depreciation to those things which were subject to wear and tear. As heretofore shown, *Article 225 of Regulations clearly provides for depreciation upon a unit of production basis and a unit of production basis is wholly inconsistent with confining depreciation allowances to wear and tear.*

It is respectfully submitted that the completed oil well is an improvement as the term is used in the statute, and a physical property as the term is used in the regulations, and that an allowance for depreciation should be made for all of the expenditures in the construction of such completed oil well. It is therefore submitted that not only the statute but also a proper construction of the regulations require the allowance of such a deduction, and that the action by the Commissioner in denying a deduction upon the cost of drilling a hole is inconsistent both with the statute and with the regulations.

II. *If the Regulations do not Require or Permit a Depreciation of the Drilling Costs, these Regulations are Contrary to the Statute and are Invalid.*

While we feel confident that the regulations of the Commissioner not only permit but require the depreciation of these so-called drilling costs, yet we submit that if these regulations neither require nor permit the same to be done, the regulations are in conflict with the express provisions of the statute and are, therefore, beyond the power of the Commissioner and are invalid.

We have heretofore shown that the statute (Section 234 (a) (8) specifically provides that in the case of oil and gas wells there should be made "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case"; we have also shown that the words depreciation and depletion are separate and distinct and have well defined meanings. This principle was recognized and announced by the decision of the Supreme Court in the case of *Ludey* v. *United States*, 274 U. S. 295. In view of the fact that some of the earlier Revenue Acts did not contain provisions for depletion and that such conditions resulted in an injustice, and that the later Revenue Acts contained specific provisions for depletion and also provided for depreciation (see *Ludey* case at p. 302), it can not be seriously contended that Congress in any manner confused the two terms.

In considering this question, we should also bear in mind the rules of statutory construction to the effect that the primary rule is to ascertain and give effect to the intent of the legislative body, and that where the language of a statute is plain and unambiguous and conveys a clear and definite meaning, resort must not be had to rules of construction but the statute must be given its plain and obvious meaning (*United States* v. *Missouri Pacific R. Co.*, 278 U. S. 269). Courts will not legislate but will construe the statutes as framed by Congress. The words will be considered as used in their ordinary sense and the literal meaning of a statute will not be departed from by the courts unless a literal con-

struction produces an absurdity so gross as to shock the general moral and common sense (*Crooks* v. *Harrelson*, 282 U. S. 55).

In dealing with taxing statutes, the general rule requiring adherence to the letter of a statute applies with peculiar strictness. See *Crooks* v. *Harrelson*, *supra*, p. 61.

In the case of *United States* v. *Merriam*, 263 U. S. 179, 187–188, the court said that in statutes levying taxes the literal meaning of the words employed is most important and such statutes are not to be extended by implication beyond the clear import of the language used.

Where, however, the language of a statute is of doubtful meaning, of course the court must construe the ambiguity, but in construing such ambiguity in a tax statute the same must be resolved in favor of the taxpayer and a taxing statute should not be extended by implication beyond the clear import of the language used (*Gould* v. *Gould*, 245 U. S. 151; *United States* v. *Merriam*, 263 U. S. 179, *Reinecke* v. *Trust Company*, 278 U. S. 339).

It is also a well settled rule that the Secretary of the Treasury can not by regulations alter or amend a revenue law (*Morrill* v. *Jones*, 106 U. S. 466), and while the regulations made by the Commissioner have the force and effect of statutes if made with the approval of the Secretary of the Treasury and pursuant to statutory authority, yet, if they are not reasonable or are in conflict with the statute, the regulations are invalid (*Burnet* v. *Moore Cotton Mills Company* (C. C. A. 4th), 49 Fed. (2) 59; *Palmer, Trustee*, v. *United States*, 67 C. Cls. 648 at 653, 654).

We respectfully urge that the statute says that both depreciation and depletion shall be allowed. Depreciation has the well established meaning of being the lessening in value of the improvements upon a property, while depletion has the well recognized and established meaning of a diminution of the natural deposits. Depletion of the natural deposits under this statute should not be confused with depreciation, and the depreciation of the improvements should not be confused with the depletion of the natural deposits. The statute is in the conjunctive and requires

that both should be allowed. See *Crooks* v. *Harrelson*, supra.

We have heretofore shown that these drilling costs become a part of the improvements put upon the property by man and are in no manner a part of the natural reserve or the mineral deposit. They are separate and distinct therefrom and any act of the Commissioner, whether by regulation or otherwise, that attempts to prevent the return of the investment in such improvements by way of depreciation is contrary to the statute and therefore under the decisions cited is invalid and must be ignored.

An examination of other provisions of Regulations 69 dealing with the question of depreciation and depletion conclusively shows that the Commissioner had in mind the distinction between depreciation and depletion and the reasons fundamental to each, and that if the regulations are not given the construction for which we have heretofore contended, it is submitted that they become unreasonable and inconsistent with each other as well as with the express provisions of the statute.

In Article 161, of Regulations 69, it is stated that:

"*Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603. Due regard must also be given to expenditures for current upkeep." * * *

Article 162 provides that:

"*Depreciable property.*—The necessity for a depreciation allowance arises from the fact that certain property used in

the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. (See sections 204 (c), 214 (a) (9), and 234 (a) (8) and articles 201–237 and 1602)." * * *

Article 163 provides that:

"*Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

Article 164 provides that:

"*Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See article 1602.)" * * *

Article 165 provides that:

"*Method of computing depreciation allowance.*—The capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in

accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable." * * *

Article 201 provides that:

"*Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions, * * * but not including land values for purposes other than the extraction of minerals. * * *

"When used in these articles (201–237) covering depletion and depreciation—* * *

"(c) A 'mineral property' is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface only as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The value of a mineral deposit is the value of the mineral property, less the value of the plant and equipment, and less the value of the surface of the land for purposes other than mineral production. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

"(e) 'Minerals' include ores of the metals, coal, oil, gas. * * *

"(g) 'Depletion or depreciation sustained' means (except in cases where a discovery value has been established, as to which see (h) below) depletion or depreciation actually sustained, whether legally allowable or not, based on the cost or value as at the basic date, as the case may be."

Article 203 provides that:

"*Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computations of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property."

Article 207 provides the method for the determination of the fair market value of oil and gas properties, and, among other things, provides that:

"* * * The development cost includes expenditures for drilling wells to maintain or increase production or to develop additional unproven areas, and the cost of improvements necessary to the development of the property, such as roads, warehouses, water lines, etc. The operating cost includes all current expenditures for producing, preparing, and marketing the oil and/or gas produced, such as pumping oil wells, repairs of oil or gas wells, cleaning sanded wells, shooting wells, re-drilling old wells, labor and supplies for collecting oil, repairs to separators, pumps, and collecting lines, repairs to buildings and structures, repairs to field tools, equipment, fixtures and machinery, superintendence, other field expenditures, overhead, etc. (due consideration being given to taxes), exclusive of allowable capital additions

as defined in article 223 and deductions for depreciation and depletion. The cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returnable to the taxpayer free from tax." * * *

From the above it will be seen that the Commissioner of Internal Revenue has recognized the distinction between depreciation and depletion. He has also recognized the fundamental basis of the theory of depreciation and has specifically said in Article 162 that it does not apply to bodies of minerals which through the process of removal suffer depletion. He has also said (see articles 164 and 165) that it is the intention to permit the return of the capital sum invested in property used in business and that this sum should be charged off over the useful life of the property either in equal annual installments or by an apportionment of the capital sum over the units of production.

In Article 201 he again expressly recognizes the distinction between depreciation and depletion where he says that in the case of mines, oil and gas wells, the taxpayers should be allowed as a deduction in computing net income "in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements." He then goes on and explains the theory that the depletion shall cover the mineral deposits.

It is respectfully submitted that if it should be held that under the provisions of Articles 221, 223 and 225 of Regulations 69 these costs can not be made the subject of depreciation, then these articles become inconsistent with the other articles of Regulations 69 which have just been discussed, and it is further submitted that Articles 221, 223 and 225 so construed become inconsistent with the express words of the statute which require the allowance of both depreciation and depletion and that such depreciation and depletion are separate and distinct and have been so recognized by the Commissioner of Internal Revenue in other articles of these same regulations.

It is manifest that Congress intended that the operation

of the provisions with reference to depreciation and depletion should permit the return of the capital investment of the taxpayer and the allowances for discovery value over the period of years of operation. It is equally manifest that an oil well as well as the investment therein will have no useful life after the oil in paying quantities has been exhausted. The arbitrary allowance for depletion is 27½ per cent of the gross income for the year. This bears absolutely no relation to the amount of money expended in the drilling of wells upon the property, but as the regulations of the Treasury Department will reveal, and as the statements by the courts in the decided cases will show, was an arbitrary figure which from experience was believed just and was arrived at in order to avoid the many difficulties in the ascertainment of depletion quantities and discovery values, but it was never meant to have any application to the recovery of the capital investment in the cost of the construction of oil wells and such operating properties.

It is clear that the statute expressly requires the allowance of a deduction for depreciation upon the entire cost of constructing a completed oil well, including the cost of drilling the hole and that if the regulations do not require or permit such deductions then they are inconsistent with other provisions of the same regulations, they are unreasonable and are contrary to the statute, and, therefore, must be disregarded.

III. *The decision by the Circuit Court of Appeals for the Fourth Circuit in the case of Burnet v. Petroleum Exploration.*

After stating some general principles of law the court at page 276 (61 Fed. (2d) 273) says that the taxpayer was given the option by Article 223 of Regulations 69 to charge the expenditures in question either to current expense or to charge them to capital account returnable through depletion, and the taxpayer having charged such expenditures to capital account with full knowledge that they would be returned only through depletion is bound by the election

so made and must accept the terms of the option. There are several answers to this theory which it is believed proves the theory to be unsound.

First. As has been heretofore set out in this brief, it is believed that a proper construction of the regulations themselves require the allowance of a depreciation upon the total cost (including the drilling costs) of a producing oil well. Also, such drilling costs are in reality only a part of the cost of placing casing and installing equipment which the Government admits are to be the subject of a depreciation.

Second. If the proper construction of the regulations does not permit a depreciation upon the costs in question then such regulations are in conflict with the statute and can not control since the statute requires the allowance of a depreciation upon these costs.

Third. Since the statute requires a deduction for depreciation upon these costs, the regulations can in no way limit the right to same or place conditions upon its allowance.

Fourth. The costs in question are in reality and in fact capital investments and the regulations can not change their character. These costs partake of the nature of permanent investments for permanent improvements, and are in fact capital investments. They should be charged to capital account. That they are not current expense has been decided by the Board of Tax Appeals in *Old Farmers Oil Co.* v. *Commissioner*, 12 B. T. A. 203; *Consolidated Mutual Oil Co.* v. *Commissioner*, 2 B. T. A. 1067, *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551, and *J. H. Hughes Oil Co.* v. *Bass, Collector*, decided December 13, 1932, by the Circuit Court of Appeals for the Fifth Circuit, and as yet reported only in Vol. III C. C. H. 1932 Tax Service, page 9476. When the taxpayer charged such costs to capital account, it merely did what was proper and required not only by

proper accounting but also by law, and the Commissioner had no right to impose any penalties or burdens upon the taxpayer for doing that which was proper and required by the law.

Fifth. There was really no option offered by the regulations. Proper accounting as well as the law required the taxpayer to charge those costs to capital account. Also, before the well was producing the taxpayer had no income from the well from which to deduct the costs as a current expense, and it may well be in many cases and especially in the case of the true pioneer whom the statute aimed to aid that he had no income from any source from which to deduct such costs as current expenses at the time such expenditures were made.

Sixth. There was in fact no advantage to the taxpayer in charging these costs to capital account instead of current expense. The real advantage accrued to those who were in position to charge such costs to current expense. Therefore when the taxpayer charged these costs to current expense and followed the only proper and legal course it made no election which placed upon it any penalties or burdens which it is now contended were imposed by the regulations. The taxpayer who charges such costs to current expense has at least two and probably more advantages over the taxpayer who follows the proper and legal course of charging such costs to capital account. (a) The taxpayer who charges the cost to current expense gets all of such costs returned at the time they are incurred and in one allowance while the taxpayer who charges the same to capital account gets such costs returned, if at all, over a long period of years. The immediate return of all is certainly more desirable than the possible return of all in deferred installments. (b) The taxpayer who charges such costs to capital account runs the risk of an inaccurate estimate of reserves preventing the return of all such costs whether returned through depreciation or depletion. The taxpayer who gets the im-

mediate return of such costs as current expense runs no such risks.

Therefore, when the taxpayer merely does the proper and legal thing by charging to capital account costs which are in fact capital investments, it only exercises and stands upon its rights under the law and does not exercise any election to accept an option thereby incurring the penalties or burdens now contended for by the Government. Such penalties and burdens are not imposed by the law and the taxpayer is free to stand and insist upon all of its rights.

The contention of the Government that such costs can be recovered only through depletion is unreasonable and would result in a discrimination in favor of those who charge off such costs as current expense. The following tabulation using a hypothetical case shows the disadvantage to the taxpayer who does the legal thing and charges such costs to capital account but who is compelled by the Treasury Department to attempt to recover same by depletion allowances. This computation is not for a single year but is based upon the total life of the oil well. For this purpose it is assumed that:

Lease Cost	$100,000.00
Oil Sales	1,000,000.00
Production Expense, etc.	100,000.00
Well Cost:	
Equipment (Assumed no salvage value)	150,000.00
Intangible Drilling Cost	150,000.00

Taxable Income Under 1926 Act.

		Drilling Cost Capitalized	
	Drilling Cost Charged off as expense	*Restored through Depreciation*	*Restored through Depletion*
Gross Income	$1,000,000.00	$1,000.000.00	$1,000.000.00
Deduct:			
Production Expense, etc.	100,000.00	100,000.00	100,000.00
Drilling Cost Charged off as expense	150,000.00	None because capitalized	None because capitalized
Depreciation:			
Of Equipment	150,000.00	150,000.00	150,000.00
Of Drilling Cost	None because Charged Off	150,000.00	None because included with depletion
Total Deductions	$400,000.00	$400,000.00	$250,000.00
Net Income—before depletion	$600,000.00	$600,000.00	$750,000.00
27½% of Gross Income	$275,000.00	$275,000.00	$275,000.00
50% of Net Income before depletion	$300,000.00	$300,000.00	$375,000.00
Statutory Depletion Allowance, 27½% Gross income or 50% net income whichever is smaller	$275,000.00	$275,000.00	$275,000.00
The Statutory Depletion Allowance Comprises:			
Return of Lease Cost	$100,000.00	$100,000.00	$100,000.00
Return of Capitalized Drilling Cost	None because charged off	None because returned thru depreciation	150,000.00
Allowance in excess of amount needed to return capital invested	175,000.00	175,000.00	25,000.00
Total	$275,000.00	$275,000.00	$275,000.00
Net Income before Depletion shown above	$600,000.00	$600,000.00	$750,000.00
Statutory Depletion Allowance	275,000.00	275,000.00	275,000.00
Taxable Net Income	$325,000.00	$325,000.00	$475,000.00

It is thus seen that the taxpayer who charges off such costs as expense or who recovers the costs by depreciation gets a discovery value return of $175,000 and pays tax on a net income of only $325,000 from the well, while the taxpayer

who relies on depletion allowance for the recovery of such costs gets a discovery value return of only $25,000 and has to pay tax upon a net income of $475,000 from the same well. In the hypothetical case used, the 27½% flat statutory allowance is greater than the depletion based upon actual cost; therefore, no advantage would be gained by taking the depletion upon the basis of costs. But even if the depletion based upon cost is greater than the flat rate of 27½%, still the taxpayer who charges off the costs as a current expense would have the advantage over the taxpayer who seeks to recover it through depletion.

This establishes that the real advantage of any alleged option is to those who charge off such costs as expense, also, that the contention of the Government renders the regulations unreasonable and discriminatory and that such contention is therefore unsound.

The Court of Appeals says: "It is true that Article 225 of Regulations 69 permits an allowance for depreciation of physical property but only so far as not to conflict with the option exercised by the taxpayer as to charging such expenditures to capital account, and such allowance is given only for such physical property as 'machinery, tools, equipment, pipes, etc.' " It is not believed that Article 225 imposes any burden or penalty upon the taxpayer or was intended to deprive it of its right to question the action of the Government in the determination of depreciation allowances. The words "so far as not in conflict with the option exercised by the taxpayer" under Article 223 can properly have but one meaning and that is that when the taxpayer exercises the "option" to charge the costs as current expense and not follow the proper and legal course of charging them to capital account then of course the taxpayer having received a return as expense of all of his costs for the well can not be allowed another deduction, and the additional allowance of more than such costs by way of depreciation. In other words, having already received a return of all costs the taxpayer will not be allowed more. Of course the taxpayer will also receive the flat rate allowance for depletion.

The Circuit Court of Appeals then concludes that the hole of an oil well is not physical property; that it is not an improvement; that it does not deteriorate or depreciate as does a piece of machinery; that when the mineral is exhausted the hole is useless and of no value, and that therefore the proper and logical method of returning the cost of drilling the hole is through depletion rather than depreciation. It is believed that what we have previously said in this brief proves that these conclusions by the court are unsound and such arguments need not be repeated here.

The Circuit Court of Appeals then says that if the cost of the hole is included in depreciation allowances as well as cost of machinery, tools, etc., then there is no expense whatever connected with an oil well left to be returned through depletion and the regulation (Article 223) is robbed of any meaning except as to exploration of the property. Here the court fails to take into consideration the cost of the land or lease which in addition to exploration costs are left to depletion and also fails to take into consideration the discovery value which did not represent actual expenditures, but which was intended to be cared for by the 27½% depletion allowance.

The Circuit Court of Appeals then holds that the construction contended for by the Government had been followed for a long time and had the implied approval by Congress and that the long continued and consistent administrative construction which has had the implied approval by Congress should not be disturbed.

It is believed that this holding is erroneous and is not supported by the facts or the law.

As has heretofore been set out, a proper construction of the regulations requires the allowance of depreciation as contended for by respondent. Even if the regulations do not require such allowance the statute does require it and any regulations to the contrary are invalid. It is clear that the regulations can not overcome the statute. If the statute requires the allowance, there is no room for the application of the doctrine of long continued administrative construction.

There has been no long continued, consistent administrative construction. Before 1918 there was no depletion allowance. Between 1918 and 1924 the statutes permitted any proper amount as a depletion allowance. From 1924 to 1926 the statute permitted not to exceed 50% of net income as a depletion allowance. In 1926 the statute was materially changed and instead of the depletion allowance being based upon costs or discovery value it was determined by an arbitrary and flat allowance based upon gross income and having no real relation to cost. Before 1926 it made no real difference whether the drilling cost was received through depletion or depreciation since both were calculated upon a unit of production basis and upon cost plus a discovery value. After 1926 the method of receiving a return of the costs became very important. We are here concerned with the tax for the year 1926, the very first year in which the Revenue Act of 1926, which made such radical changes, was in operation. In these circumstances it can hardly be said that there was a long continued, consistent administrative construction or that Congress had approved same.

Further than this, it has been heretofore shown that any taxpayer and Congress was justified in believing that the regulations did require the allowance of depreciation as respondent contends, and if such regulations did not permit such allowance they were so uncertain and inconsistent with other provisions of the regulations as to render taxpayers and Congress unable to say what the regulations meant. It is respectfully submitted that any developer of oil wells as well as Congress was entirely justified in believing that when the regulations required a depreciation upon physical properties it included a completed oil well and did not require the arbitrary segregation of the costs into classes created by resort to unreasonable requirements and refinements.

An examination of Regulations 45 under the Revenue Act of 1918, Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924, and Regulations 69 under the Revenue Act of 1926, reveals that there was not in fact a long standing, consistent, and definite interpretation by the Treasury Department upon the ques-

tion of depletion and depreciation in oil and gas wells. The very fact that in the Revenue Act of 1926 a flat deduction of 27½ per cent of gross income was substituted as the allowance for depletion in lieu of the former allowance based upon a discovery value and a unit of production basis shows that there could have been no consistent action upon this question prior to the Revenue Act of 1926 which was applicable to that act. Regulations 45 issued under the Revenue Act of 1918 are so entirely different that an effort to compare them with the later regulations seems futile. Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924, and Regulations 69 under the Revenue Act of 1926 are all somewhat similar upon the questions of depreciation and depletion of mining oil and gas properties. These regulations are found in Articles 201 to 226 both inclusive of the respective regulations. It will be noted, however, that in Articles 202, 203, and 204 of Regulations 69 under the Revenue Act of 1926 the following sentence appears which does not occur in any of the prior regulations: "The provisions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on income from the property." Article 214 of Regulations 69 specifically provides that if by reason of the youth of the field or for any other cause it is not possible to determine with any degree of certainty the quantity of oil or gas on the property "the deduction for depletion shall be based upon the income from the property." The quoted portion does not appear in prior regulations, but other provisions are made. The title of Article 215 is changed in Regulations 69 so as to exclude from its provisions depletion based upon income, and the last sentence of the article provides that if the deduction is computed on the basis of income we should see Article 221.

Paragraph (e) of Article 216 of Regulations 69 is new and is made necessary because of the application of the flat rate of deduction for depletion, and the last sentence in that Article also refers to Article 221 for depletion on oil and

gas wells. Article 221 of Regulations 69, providing for depletion of oil and gas wells, is new and reads as follows:

"Art. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

All of the above clearly shows that there was such a change in the Revenue Act of 1926 in dealing with depreciation and depletion in oil wells that it can not be said that the prior regulations constitute a long-standing, administrative interpretation of the Revenue Act of 1926 or an implied approval thereof by Congress.

Petitioner has attached as a part of Appendix A to its brief herein (p. 25 to 29) Treasury decision No. 4333. This should have no bearing upon the case. It is dated April 11, 1932. The petition was filed in the Court of Claims on October 9, 1930. The claimant's brief was filed in that court on January 13, 1932, and the Government's brief on April 7, 1932. It thus appears that the Treasury decision is in the nature of a self-serving statement issued by the Government just after the Treasury Department had prepared its brief in this case. The decision is also directly opposed to the prior decisions of the Board of Tax Appeals in four different cases, namely, *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551; *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Co.* v. *Commissioner*, 24 B. T. A. 360. Since this Treasury decision is an attempt to explain the regulations and the alleged prior administrative action which it is stated is of long standing, it

constitutes an admission that the prior regulations and alleged administrative action are not clear or understood and need explanation even to the various Collectors of Internal Revenue to whom it is in part addressed. It should be noted in this connection that the Board of Tax Appeals, which certainly is familiar with tax matters and the interpretation of tax statutes and regulations, had then held that under the regulations the costs involved in this case were subject to depreciation (see *Jergins Trust* v. *Commissioner*, 22 B. T. A. 551). But even if we examine the contents of the Treasury decision we find that it is so uncertain, indefinite, inconsistent, and confusing as to not convey a definite idea to any one upon the matters involved in this case. For example, on page 26, it is stated that the option to charge to current expense or to capital account applies to "hauling and supplies." On page 27, the decision says: "In general, this option applies only to expenditures for those drilling and development items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value even though used in connection with the installation of physical property which has a salvage value." Yet, on page 28, it is stated that if the taxpayer charges such costs to capital account "in so far as they are not represented by physical property," they are returnable through depletion, and that if such expenditures are charged to capital account in so far as represented by physical property they are returnable through depreciation, such expenditures so subject to depreciation "are, amounts paid for wages, fuel, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks or other physical structures."

In the face of this confusion, can it properly be said that Congress approved the alleged administrative interpretation of the statutes and the regulations or that Congress or any one else even understood what was the alleged administrative action. Certainly they can not be used to overcome the positive and mandatory provisions of the statute.

CONCLUSION.

For the reasons heretofore stated it is respectfully submitted that the decision by the Court of Claims should be affirmed.

Respectfully submitted,

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